The Texas economy continued to expand in August, albeit at a slower pace. Businesses appear still reluctant to expand production on heightened policy uncertainties (including lingering expiration of the Bush tax cuts and the federal ban on offshore oil drilling) and worries over the U.S. and global economic outlook.

On a positive note, both Texas Leading and Business-Cycle Indices indicate that the economic recovery is gaining traction. In particular, the services industry has seen a moderate improvement in demand thanks to stronger retail trade and more stable air travel and freight traffic demand. However, falling home sales and weak private consumption may put pressure on economic growth in the second half of 2010 as manufacturing-driven inventory restocking loses momentum.

That said, personal consumption is a relatively smaller contributor to growth in Texas compared to the nation as a whole; and State manufacturing relies less on the construction industry. Indeed, being the biggest exporting state in the U.S., Texas will continue to benefit from the buoyant demand for energy and capital goods from overseas markets. This helps make Texas more resilient to the tepid recovery in consumer demand nationwide.

In fact, Texas nonfarm employment is recovering faster than the national average, partially due to stronger job growth in the private sector. And more stable home values, and a lower share of households with negative equity, improve the flexibility of the local labor market. Indeed, there are fewer obstacles to labor mobility in Texas, which allows for more efficient relocation of workers to areas where jobs are available.

That said, the construction industry remains a particularly soft spot both in Texas and nationally. Home sales continued to decline in July, for the second straight month, following the expiration of the homebuyer tax credit. On the upside, record low mortgage rates (which are likely to be maintained in the near term thanks to an exceptionally accommodative monetary policy), as well as a considerable drop in supply of new homes, will help keep house prices stable.

Lastly, the export-led rebound shows no sign of abating in Texas. In fact, Texas exports are growing at a significantly faster rate than other large exporting U.S. states and the nation as whole. This outperformance is due to the surging demand for energy and capital goods from emerging markets.

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Economic output

All in all, August economic data was mixed, indicating continued, albeit slowing, growth in manufacturing. According to the Texas Manufacturing Outlook Survey, conducted by the Federal Reserve Bank of Dallas, the state’s manufacturing output remained more or less flat for the third straight month. The company outlook index turned positive, after declining for two consecutive months. Meanwhile, the employment index fell below zero, for the first time since January, on rising layoffs and shorter hours worked (see chart 1). The Houston Purchasing Managers Index stood unchanged in August, implying slower expansion of economic activity. The federal government ban on offshore oil drilling as well as other regulatory uncertainties may partially explain why this index stalled at relatively low levels in the third quarter. Nationwide, growth in the manufacturing sector continued for the 13th consecutive month and the ISM manufacturing PMI increased to 56.3% in August (see chart 2). At the same time, the services industry grew at a slower rate, with ISM non-manufacturing PMI easing to 51.5%.

In July, the Texas Leading Index grew by 0.8%, versus the month before, and was 6.2% higher than a year ago. Higher oil prices, lower unemployment insurance claims, and better labor market conditions contributed most to this improvement. The Texas Business Cycle Index increased for the seventh straight month, indicating that the Texas economy remains in recovery mode (see chart 3). Metro Business Cycle Indices point to improving economic conditions in Austin, Dallas, Fort Worth and Houston (and San Antonio appears to also be turning the corner (see chart 4)).

According to the Dallas Beige Book, a survey of the overall economic conditions by the Federal Reserve Bank of Dallas, the energy sector continues to support economic recovery in Texas. Indeed, in July, output in the mining industry was up by nearly 13% compared to a year ago. Production of durable goods grew by 2.6%, in annual terms, ensuring 0.6% growth in manufacturing. As a result, industrial production gained 4% versus July 2009.

The Texas services industry is gradually returning to growth as well. In July, retail sales were up by about 4% (compared to a year ago), although month-over-month growth eased somewhat compared to the first quarter of 2010. Meanwhile, demand for professional, technical and administrative services is also recovering (which drives recent employment gains in these sectors). The transportation industry is growing thanks to a higher volume of shipments and more stable air travel demand. In particular, both the Dallas and Houston Airport Systems report growing passenger traffic and a solid rebound in freight traffic. At the same time, the financial sector remains flat on weak demand for business loans. Uncertainty over the latest financial reforms are clouding the industry’s outlook as well. Lastly, the real estate industry is still depressed on sliding home sales and subdued demand for non-residential construction.

All told, the latest data points to slower growth, partially due to further deceleration in manufacturing. Inventory restocking, which sustained economic activity during the first two quarters of this recovery, is tapering off. Having said that, the ratio of business inventories to sales is still well below its pre-crisis level. However, this ratio started to grow again in May, having dropped sharply at the beginning of
2009 (see chart 5). And a rebound of retail sales and exports is leveling out (see chart 6), which is likely to reduce the need to rebuild inventories in the future. In fact, the second quarter GDP growth was revised down to only 1.6% compared to 3.7% the quarter before due to a smaller contribution from private inventories.

Falling home sales, and low volumes of commercial real estate activity, continue to depress the U.S. construction industry. This means that manufacturing sectors tied to construction will struggle to recover as the housing market remains distressed.

Finally, both households and businesses face higher uncertainty over taxes and other macro-economic policy, which impacts investment and consumption decisions. In particular, according to the Federal Reserve, the U.S. nonfinancial firms held $1.85 trillion in cash or other liquid assets (or about 7% of their total assets) in the second quarter of 2010. This clearly shows that businesses are still cautious about investing in new equipment or hiring additional workers.

Employment

In July, the Texas seasonally adjusted unemployment rate remained unchanged at 8.2%; well below the U.S. unemployment rate for the 43rd consecutive month (see chart 7). Unlike the nation as a whole, where nonfarm employment fell for the second straight month in July, Texas has seen job growth every month in the first half of 2010. In July, Texas nonfarm employment fell by 5,400 jobs; yet it was 1.2% higher than a year ago. Meanwhile, nationwide, nonfarm employment was essentially unchanged (increasing by only 71,000 jobs compared to July 2009). The labor markets are particularly weak in big recession-hit states, which weigh down the overall employment data. For example, California still has 117,300 less nonfarm jobs than a year ago (down by 0.8%), employment in New York is 56,700 lower than in July 2009 (down by 0.7%), Nevada lost 20,700 jobs over the past 12 months (down by 1.8%), and Florida created only 7,800 jobs. Meanwhile, Texas boasts 125,000 new nonfarm jobs versus a year ago.

The Texas private sector created 87,000 jobs over the last twelve months - up by 1%. Nationwide, excluding Texas, private sector employment grew by only 75,000 (or up by 0.1% versus July 2009) due to weaker private sector hiring in most large local economies. Indeed, California still has 0.8% less jobs in the private sector than a year ago, and Nevada has 2.4% fewer private-sector jobs. Private sector job growth in New York, Florida and Pennsylvania (0.4%, 0.3% and 0.7%, respectively) is still modest compared to Texas.

In addition, industries that are emerging from the recession report faster employment growth in Texas than nationwide. In particular, in July the 12-month change in employment in mining and logging was 10.6% in Texas compared to only 9.3% in the rest of the country. Over the past 12 months, Texas manufacturing companies have added 14,200 jobs (up by 1.7%). Meanwhile, the U.S. still has 33,000 fewer manufacturing jobs than in July 2009 (down by 0.3%) due, in particular, to continued job losses in California, New York, Pennsylvania and North Carolina. Employment in the financial sector grew by 0.4% in Texas versus July 2009; while for the nation as a whole it was still nearly 2% below last year's level. Equally important, annual job growth in Texas' professional and business service industries stood at 2.4%; while the U.S. saw an increase of only 1.8%. Education and healthcare expanded employment by 3.3% in Texas versus

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According to the Input-Output tables of the U.S. Bureau of Economic Analysis, manufacturing of wood products, non-metallic mineral products, fabricated metal products, electric appliances and furniture rely most on the construction industry. In particular, the U.S. construction industry constitutes 40%, 52%, 21%, 23% and 17% of total final output of these sectors, respectively. However, Texas manufacturing appears to be less exposed to the construction sector. Indeed, those five manufacturing sectors account for nearly a fifth of total valued added in national manufacturing versus only 16% in Texas.
only 2% nationwide. Lastly, the Texas leisure and hospitality industry added 15,400 jobs over the past 12 months (up by 1.5%), while nationwide they increased only 0.1%.

Several factors explain the stronger employment trends in Texas. Above all, compared to Texas, the US as a whole appears to face more formidable obstacles to job creation. First, the housing bust and a collapse of consumer demand for durable goods triggered large job losses in construction and manufacturing. Since the beginning of this recession in December 2007, U.S. nonfarm employment shrank by about 7.6 million workers (down by 5.5%) with over half of all new unemployed coming from these two sectors alone. Meanwhile, in July, Texas nonfarm employment was only 1.3% lower than in December 2007, thanks in part to smaller job losses in construction and manufacturing (Texas lost 10% of its manufacturing and 14.7% of its construction jobs since December 2007 versus 15% and 25% nationwide). This is important, because the skills those who lost jobs do not necessarily suit the demand for workers in sectors that weathered this downturn relatively unscathed, such as education and healthcare. Indeed, the relationship between the unemployment and job vacancy rate (known as the Beveridge Curve) points to a growing skills mismatch as increasing vacancies still fail to bring the unemployment rate down (see chart 8). This partially explains why over 40% of all unemployed persons have remained jobless for 27 weeks or more.

In addition, the distressed housing market exerts a toll on workers' mobility, which makes labor markets less flexible. According to CoreLogic, nearly a quarter of all U.S. households are still stuck with homes that are worth less than their outstanding mortgages. This makes it more difficult for people to move to places were jobs are available. The share of households in negative equity has been declining recently, thanks to a recovery in housing prices (nearly one third of all mortgaged properties were in negative equity at the end of the second quarter of 2009). However, 68%, 50%, 46% and 33% of households in Nevada, Arizona, Florida and California owe more to the banks than the current value of their homes. In the second quarter of 2010, only 11% of all mortgaged properties in Texas were in negative equity.

Lastly, being the largest exporting state in the U.S., Texas relies more on the strength of overseas markets. This means the state's economy is less sensitive to the slow recovery of U.S. personal consumption. Indeed, several factors suggest that the share of personal consumption relative to the size of the economy is smaller in Texas than in the U.S. First, exports of goods account for about 15% of the Texas economy (compared to only 9% nationwide). Second, personal disposable income, which is a key determinant of personal consumption, is only 68% of Texas economic output (versus 76% in the U.S. as a whole). This implies that personal consumption is less important as a source of growth for the Texas economy. As a result, a faster recovery in manufacturing jobs in Texas, versus the rest of the country, has been sustained due to the much stronger rebound of exports vs. personal consumption.

Monetary policy and asset prices

U.S. monetary policy will remain supportive of economic growth as the sluggish pace of economic recovery and subdued inflation prompt the Fed to keep borrowing costs low. In particular, the Federal Reserve pledged to maintain a floor on its domestic securities holdings by about $2 trillion (by reinvesting principal payments from agency debt and agency mortgage-backed securities (MBS) in longer-term Treasury securities). Since the beginning of 2009, the Fed has noticeably expanded its purchases of agency and Treasury securities to support mortgage lending and maintain low long-term interest rates (see chart 9). In fact, as of September 15th 2010, agency debt and MBS held by the Fed stood at $1.25 trillion (or over 60% of all SOMA holdings versus only 7% at the end of 2008). However, a reduction of MBS held on the Fed balance sheet

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*System Open Market Account (SOMA) is a portfolio of securities held by the Fed, which contains Treasury and agency securities purchased in the open market.
*Agency debt comprises direct obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Agency mortgage backed securities comprise MBS guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae.
*Under the large-scale asset purchase programs (LSAPs), the Fed pledged to purchase up to $200 billion of agency debt, $1.25 trillion of agency MBS, and $300 billion of Treasury securities.
(due to principle repayments) risks pushing up long-term interest rates. As a result, in August, the Fed made a decision to buy more long-term Treasury securities. This means the Fed is likely to postpone a reduction in the size of its balance sheet until the U.S. economic recovery gains traction. Furthermore, with slow private sector job growth, and soft housing markets, it is still too early to rule out a resumption of Fed purchases of agency MBS as well.

Notwithstanding this exceptionally accommodative monetary policy, the housing market remains distressed. According to the National Association of Realtors, July's existing home sales fell to a seasonally adjusted annual rate of 3.83 million from 5.26 million in June (down by 27%); and were 25% lower than a year ago. The Texas housing market is following a similar trend with home sales falling for the second straight month since the expiration of the home buyer tax credit (see chart 10). Two discernible peaks in the home sales data7 imply that the residential housing market is still struggling to turn the corner absent government backing.

Despite record low mortgage rates, the pool of creditworthy borrowers continues to shrink, especially in large recession-hit states where foreclosure rates remain high and households are stuck in a negative equity trap. For example, in August, one in 194 housing units in California, one in 84 in Nevada, and one in 155 in Florida, were in foreclosure.8 Only one in 672 housing units were in foreclosure in Texas, which compares well with the one in 381 foreclosure rate nationwide. Clearly, a large number of bank-owned foreclosed properties will delay a more solid recovery in the housing market. However, on a positive note, the supply of new homes has considerably shrunk since the beginning of this recession (chart 11), which should help sustain relatively stable housing prices going forward.

Foreign trade

An export-led recovery continues in Texas, with exports growing by 28.9% during the first seven months of 2010. Meanwhile, exports in five of the other largest exporting states (California, New York, Florida, Washington and Illinois)9 are recovering much slower (up by 22%, 13%, 17%, 3% and 18%, respectively); which puts the growth of exports nationwide at only 22.6%. Texas is benefitting from higher demand for both energy and capital goods from emerging markets. In particular, exports of industrial machinery and computers were up by 10%, exports of electric equipment were up by 29%, and exports of vehicles were up by 72%.10 Exports of mineral fuels, organic chemicals, and plastics (one third of all exports from Texas) bounced back by 58%, 47% and 29%, respectively. Texas' exports to Mexico, China and Brazil (over 40% of all exports) grew by 33%, 15% and 49%, respectively. In addition, exports to Canada, Korea, Singapore, Taiwan and Japan (about one fifth of all exports) performed well on stronger growth momentum in these countries versus other developed economies. Indeed, exports to the Euro area (less than 8% of all exports) stood flat due to a sharp drop in energy consumption in Europe (exports of mineral fuels from Texas to the Euro area declined by 48%). Still, notwithstanding a stronger U.S. dollar, Texas exporters managed to offset this drop with a higher volume of exports of manufacturing goods. In particular, exports of organic chemicals to the Euro area grew by an impressive 70.6%, while exports of plastics grew by 32.3%.

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7Both occurred at the expiration dates of the initial and extended homebuyer tax credits in November 2009 and April 2010, respectively.
8Source: RealtyTrac.
9These states (including Texas) account for about 45% of total U.S. exports.
10These commodities represent 40% of total exports from Texas.